THE PRO UK INVESTMENT STRATEGY

3 Shares Under The *PRO* 'Spotlight'

The Motley Fool® Pro

Contents

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Introduction

Dear fellow Fool,

In this report, we're sharing three *Spotlight Shares* that aren't current Buy recommendations, but that we're watching closely as potential future additions to the *Pro* portfolio.

The **Growth**, **Income**, and **Covert Value** strategies we use in *Pro* are all represented in this report.

The only *Pro* strategy not represented in this report is **Special Situations**. The window of opportunity for Special Situations tends to be brief, and we don't happen to have any such shares that we're watching right at this moment. But we do have a few such positions in the portfolio currently, and we're always looking out for additional opportunities.

We think each of these companies in this report could become compelling opportunities, and we hope you enjoy learning a little bit about each business, and also how we assess potential investments.

Fool on!

Nathan Parmelee
Portfolio Manager
Motley Fool Pro UK

discoverIE

"A growth company to watch"

by Nathan Parmelee

What it does

Designs, manufactures and distributes custom electronic products.

Why watch?

- *Consistent growth of sales and cash flow, bolstered by a bolt-on acquisition strategy.*
- *Expanding margins and return on capital since shifting to a design and manufacture approach.*
- *Fragmented industry leaves room for continued growth.*

Category	Industry	Ticker	Market Cap	Recent Price
Growth	Electronics	LSE: DSCV	£303m	424p

Headquarters	Website
Guildford, Surrey	www.discovereplc.com

Price data as of 13 April 2018.

About The Company

Acquisition-led companies have earned a bad reputation with investors, because integrating the processes and cultures of many different companies can be difficult to do. We think large, complex acquisitions deserve this stigma, but there are other types of acquisitions that we believe can make sense and add value.

We're particularly fond of small, bolt-on purchases of companies in the same line of business as the acquirer, and become even more interested if the distribution processes of an acquired company's products can be readily improved.

It helps that we've had success in *Pro* with companies that fit this mould. **Post Holdings** (NYSE: POST) is a good example, and we think **discoverIE** (LSE: DSCV), though in a different industry, has similar potential.

The Business

discoverIE, known as Acal until late last year, operates as two distinct business units, but they feed off each other. The Design and Manufacturing (D&M) business creates custom electronic components for customers, and accounts for 57% of sales.

The second business unit is Custom Distribution. It generates the remaining revenue, and is purely a distributor of parts. Some of those parts are made by the D&M business, but most come from other manufacturers.

If you looked back several years, you would see a business dominated by the distribution side, because management was just launching its strategy to focus on building out design and manufacturing services. We think this was a wise move, because of the higher margins in developing custom parts, and the repeat sales that can follow from being the original manufacturer.

The strategy involved building the D&M business via acquisitions. And while the distribution business isn't as profitable, it has been a consistent source of sales leads for the D&M business. These leads have helped the acquired businesses grow faster than they might have if they had remained independent.

The acquired businesses have four broad areas of specialisation (Power & Magnetics, Communication & Sensors, Electromechanical & Cabling, and Microsystems), and they have also begun to provide sales leads to each other. So, even if one part of the D&M business can't meet a new request from a customer, they're sometimes able to collaborate with another group company, or put the customer in touch with the member of the group that can meet their needs.

With the focus on growing the D&M business and on faster expanding markets, discoverIE has seen its growth rate improve, too. That's clear in its average annual sales growth of 17% over the last three years, but even more clear in how the company has grown its operating profit by an average annual rate of 30% over the same period.

The Management

Nick Jefferies has been CEO since 2009, and has led discoverIE's change in strategy. With more than three decades of experience in electronic components, Jefferies has the background for the job and, at 51, he should be young enough to remain in charge for a few more years yet.

Valuation and Key Metrics

We've already noted discoverIE's impressive growth over the last three years, and that performance has continued in the half year to September 2017, with sales improving by 15% at constant exchange rates, and 21% overall. But we were most impressed with the 9% organic growth figure. This tells us acquisitions are bolstering growth, and are not the sole source of expansion.

Despite its recent impressive growth, discoverIE still trades for a reasonable 12.5 times EBITDA (earnings before interest, taxes, depreciation, and amortisation), and roughly 20 times operating cash flow. We believe these are attractive multiples relative to discoverIE's long-term growth potential.

With most companies, we're concerned with return on invested capital, cash flow, and balance sheet health, but we're even more focused on these metrics when we see a company following a growth strategy bolstered by acquisitions. So far, discoverIE is doing well on all three fronts.

Operating margins have been slowly expanding. This is something else we like to see from an acquisitive company, because it tells us the company has the ability to grow profit more quickly than sales, and that sales growth isn't coming at the expense of profit.

Risks

Growth can hide underlying problems in companies that have been cobbled together by numerous acquisitions. We don't see reason for concern with discoverIE at this time, because its return on invested capital is steady, its operating margins are improving, and its balance sheet looks strong. Generally speaking, one or more of these metrics is in decline if there are underlying problems at acquisition-led companies.

The shift in strategy to design and manufacturing happened when the global economy was in relatively good health, so we haven't seen how the business might respond to a widespread economic contraction. We believe the business is economically sensitive, and that we'd see sales decline slightly in a recession, due to new product development slowing down. We'd expect this effect to be temporary, however, and that the long-term trend of sales growth would thereafter resume.

Foolish Final Thoughts

It's tempting to label discoverIE as a roll-up acquirer, since its industry is fragmented, and it is acquiring smaller competitors and blending them together under one corporate umbrella. However, rollups are mainly done to gain scale and efficiency, and that's not what we see when we look at discoverIE.

Instead, we see a company that is acquiring skills and capabilities its customers are asking for, and then giving the acquired companies additional sales opportunities. We think that's a much more attractive strategy for continued organic growth, and one that's likely to prove more sustainable.

Card Factory

"An income stock to watch"

by Ian Pierce

What it does

Owns a chain of greeting card and gift stores across the UK.

Why watch?

- *High levels of cash flow support a hearty dividend.*
- *Industry-leading margins due to a vertically integrated business model.*
- *Growth potential from store rollout and rising general merchandise sales.*

Category	Industry	Ticker	Market Cap	Recent Price
Income	Retail	LSE: CARD	£816m	239p

Headquarters
Wakefield, West Yorkshire

Website
www.cardfactory.co.uk

Price data as of 13 April 2018.

About The Company

While it may seem that card giving is something that's going out of fashion, the industry has surprised critics by staying relatively resilient in the face of changing consumer habits.

Although the advent of e-mail and Facebook means we don't have to send out cards to dozens of people for myriad occasions, domestic sales of greeting cards have been remarkably stable in recent years.

But within this low-growth market, **Card Factory** (LSE: CARD) has been growing by leaps and bounds, thanks to its low prices and its impressive profit margins. These high margins are possible due to its in-house design team, owning its own manufacturing plant, and having centralised warehousing facilities that cut down on costs.

The combination of top-line growth and high margins have allowed the group to gain market share from higher-priced, lower-margin competitors in recent years.

Hard-to-beat prices and high-quality products appear to have won over consumers, and have led Card Factory to post six consecutive years of like-for-like sales growth. Top-line growth has been even more impressive, thanks to its store rollout programme.

On top of this growth record, high levels of cash generation have allowed the group to open new stores and pay investors a generous level of dividends since going public in 2014. We believe this combination makes Card Factory well worth keeping an eye on as a potential addition to the *Pro* portfolio.

The Business

As its name suggests, greeting cards are the company's core business. In the year ended January 2018, sales of single cards and boxes of Christmas cards accounted for 56% of total turnover. The majority of the company's cards sell for under £1, with 99p the most common pricing point. Much of the remainder of the firm's turnover is supplied by general merchandise such as gift supplies, party supplies and holiday trinkets.

Non-card items accounted for around a third of sales in 2014, but have been become an increasingly important part of the business since, and now account for 44% of turnover. The majority of these items are priced from 99p to £4.99, so the main competition tends to be general discounters. We believe this part of the business should prove resilient against online competition, due to the low prices involved, the impulse nature of these types of purchase, and the inefficiency of online deliveries for these items.

Over the past year, the company's track record of success has come under pressure. Margins have fallen, due to to the weaker pound increasing the cost of general merchandise and card inputs that are purchased overseas, and the new National Living Wage increasing staff costs. Card Factory's management team has decided to absorb these rising costs, rather than passing them on to consumers. While this has resulted in a temporary hit to profitability, it also gives the company a great opportunity to ratchet up the pressure on competitors, who are less able to absorb these costs due to their lower margins.

Judging by the group's falling share price over the past year, some investors don't approve of this strategy. However, we believe it's the right move, as the group's high cash flow and positive sales growth should mean it's well-positioned to steal a march on rivals, while in the medium term support an impressive ordinary dividend, together with large, occasional special dividends.

The Management

Card Factory's CEO, Karen Hubbard, is a relatively new arrival having joined from B&M in early 2016. It's still early days, but thus far we've been pleased with her performance and the decisions she's made during a more difficult time for the company, due to the external headwinds it has faced.

Valuation and Key Metrics

Card Factory has made significant progress by increasing its store count from 664 in 2013 to 913 at the end of 2017. Over the next three years, management is planning to open 50 new stores a year, and sees the potential for some 1,200 across the UK in the long term.

However, what we think is most impressive is the group's record of like-for-like growth over this period, with six consecutive years of like-for-like improvements. The year ending January 2018 saw an increase of 2.6%, which was a significant improvement on the 0.4% increase registered in the previous year.

Profits did fall in the year ended 31 January 2018, due to the aforementioned cost pressures, and only limited profit growth is expected in the current year. And while management said it was hoping to pay out a special dividend of 5-10p later in 2018, this would be lower than the 15p per share special dividend that was paid out in 2015, 2016 and 2017.

We understand why this is frustrating for investors who were considering these extra distributions as a regular annual payout, but we think it's a mistake to think of special dividends in this fashion. Card Factory's ordinary full-year dividend of 9.3p appears well-covered, and still offers a historical yield of 3.9%.

The business is still generating significant cash flow, and management can lower the special dividend or cut back on store expansion plans to conserve cash if necessary, so we aren't too worried about the increase in net debt expected in the upcoming full-year results. Furthermore, with the shares valued at around 12 times earnings, we think the company's valuation is quite attractive.

Risks

The pound has been strengthening in recent months, but the nature of Card Factory's import-heavy business model means it might be vulnerable to any future weakening of sterling. Its competitors are, too, but there's always the risk management may prove unable to trim costs, or to raise prices enough to maintain the company's high profit margins, should such currency weakness persist.

For now, the group's store rollout plan seems to be going well. However, plenty of retailers have over-expanded when business is booming, only to be stung when trading trended downwards. So far, we don't think Card Factory's expansion is getting out of hand, with new stores still generating good profits. But there might come a point when management has to call a halt to its rollout strategy, and there's always a risk they make this decision too late.

Foolish Final Thoughts

Although Card Factory is facing a tough period of cost inflation, we think it is well positioned with several attractive options available to it. With high cash generation, management could scale back store openings to boost dividends, or continue to focus on taking market share while lowering its special payouts. Either way, we think the company's strong competitive advantage, robust record of increasing like-for-like sales, and impressive regular dividends mean investors should benefit over the long term.

Elementis

"A 'covert value' company to watch"

by Nathan Parmelee

What it does

A global specialty chemicals company serving a wide range of industries.

Why buy?

- *Benefiting from a shift to more predictable and faster growing personal care sales.*
- *Potential for margin expansion.*
- *A reasonable-looking valuation, relative to improving growth prospects and potentially more consistent financial performance.*

Category	Industry	Ticker	Market Cap	Recent Price
Covert Value	Chemicals	LSE: ELM	£1.4bn	297p

Headquarters
London

Website
www.elementisplc.com

Price data as of 13 April 2018.

About The Company

Our definition of value investing is a little more nuanced than only buying companies below a certain P/E ratio. We don't mind buying what we think is a good company at 10 times earnings, but it's pretty rare that we come across that combination.

Instead, we're more likely to buy a company trading at a middle-of-the-road earnings multiple where we think it has an underappreciated competitive advantage. Often this can come from a change in strategy, which is what we see happening at chemical maker **Elementis** (LSE: ELM).

Elementis has made chemicals for the consumer goods industry its primary focus, and we think this should lead to higher profit margins, a higher return on invested capital, and ultimately more consistent cash flow. That's a powerful combination that we think could also lead to a premium valuation within this sector.

The Business

Elementis is divided into four segments, defined by the customers they serve. Those four units are Personal Care, Energy, Coatings, and Chromium. The first three were formerly in one unit known as Specialty Chemicals, but we prefer the new arrangement as each segment has different dynamics, and we want to be able to scrutinise each of them individually.

The year ending December 2018 should be the first period Elementis reports using this new structure, but we already know from the 2017 results that Personal Care was the biggest profit contributor. This was largely driven by last year's acquisition of SummitReheis, a global leader in manufacturing the active ingredients in anti-perspirants.

This acquisition immediately gave Elementis' personal care segment more scale, and it also provides a large base of customers to sell its existing products to. We think the latter point is important, because Elementis' strength in personal care is in rheology, or the science of thickness and viscosity control in liquids.

In personal care, rheological additives are used to tweak the consistency of creams, make-up and sun-care products. They're also used to ensure active ingredients are equally dispersed in a product, which is where the direct tie in with SummitReheis comes in. In the long term, these customer relationships can also be used to establish sales of newly developed products, too.

Personal Care is a growing part of the overall business and its main focus, but until recently it was the Coatings business that delivered the most profit. Its end sales are more cyclical, but the underlying technology behind some of the products sold is similar, with Elementis providing the rheology expertise that gives paint and other coatings their desired consistency.

Beyond rheology, Elementis also makes additives that make the paint used for bridges and shipping containers rust-proof, and other additives that make bathroom and kitchen paint more water- and stain-proof respectively.

Energy is the smallest of the specialty-chemical focused segments, and here Elementis' rheology expertise comes in the form of products used to equally disperse the water and sand used in the fracking products that produce oil and gas from shale deposits in North America. These are cyclical sales, but we think there is global growth potential in the years ahead.

The Chromium business is a cash-cow that sells chemicals designed to make products more durable. They are used in timber treatments, leather production and aerospace alloy manufacturing.

Elementis is the only manufacturer of chromium chemicals in the US, and this exclusivity has resulted in defensible and profitable sales. The company utilises the strong cash flows from this part of its business to make bolt-on acquisitions, and to fund the expansion of its other three segments.

The Management

Paul Waterman joined the company as CEO in February 2016. So, he is relatively early in his tenure, but it is under his leadership that the business has sold smaller, non-core businesses, and invested to make Personal Care its primary focus. There are limited results for us to highlight at this point, but in our experience businesses that focus on their strengths, and that withdraw from weaker areas tend to do well, and we like what we see in this regard at Elementis.

Valuation and Key Metrics

At around 14.5 times EBITDA (earnings before interest, taxes, depreciation, and amortisation) and 17.5 times earnings, Elementis doesn't look shockingly cheap. But we think these are very reasonable multiples, especially when we consider that the earnings used in these calculations don't include a full year of profit contribution from SummitReheis, the 11% organic sales growth for the entire business in 2017, and 23% growth from Elementis' existing personal care business.

We plan to watch the balance sheet closely. Traditionally, Elementis has operated with a net cash position, and if no significant acquisitions or capital expenditures were required, half of its cash on hand was paid out as a special dividend.

A similar dividend policy is still in place, but the debt from the recent acquisition of SummitReheis has effectively put special dividends on hold. We won't mind seeing the company make smaller bolt-on acquisitions to bolster its presence in personal care or coatings, but we're looking for Elementis' strong cash flow to bring its debt balance down gradually.

Risks

Prior to the SummitReheis purchase, Elementis had been largely focused on smaller acquisitions. The integration of SummitReheis appears to be going well, so we're not concerned with this particular deal. However, if we saw another large acquisition that was largely debt-financed, we might begin to get concerned about the health of Elementis' balance sheet.

Chemical sales are generally cyclical. The focus on personal care should help to mitigate this risk, because people tend to continue buying the products they're familiar with. However, Elementis needs to continue partnering with customers on product development to create new products that meet the needs of its customers. Watching research and development spending, and the pace of new product introductions should help us assess this risk.

Foolish Final Thoughts

Elementis' recent growth looks impressive, and we think the shares are valued reasonably relative to its growth rate. But it's the long-term improvement in its operating margins, and more consistent cash flow that we believe make the shares compelling, and could mean the shares achieve a higher valuation in the years ahead.

Risk Warning

» All shares, and the income from them, can go down as well as up.

» You run an extra risk of losing money when you buy shares in certain smaller companies including "penny shares".

» There is a big difference between the buying price and the selling price of these shares. If you have to sell them immediately, you may get back much less than you paid for them. The price may change quickly, it may go down as well as up and you may not get back the full amount invested. It may be difficult to sell or realize the investment.

» You should not speculate using money you cannot afford to lose.

» Some securities may be traded in currencies other than sterling, and may also pay dividends in other currencies. Changes in rates of exchange may have an adverse effect on the value of these investments in sterling terms. You should also consult your stockbroker about any additional dealing or administrative charges.

» We have taken all reasonable care to ensure that all statements of fact and opinion contained in this publication are fair and accurate in all material aspects.

» Investors should seek appropriate professional advice from their stockbroker or other adviser if any points are unclear.

» This report gives general advice only, and the investments mentioned may not necessarily be suitable for any individual.

About The *Pro* Investment Strategy: 3 Shares Under The *Pro* 'Spotlight'

For all queries about this report please email *Pro*@Fool.co.uk. Alternatively you can call us on **0207 462 4300** between 9am-5pm, Mon-Fri (except for public holidays).

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